

06-0179

AUDIT

TAX YEAR: 2000, 2001, 2002, 2003, 2003

SIGNED: 10-23-08

COMMISSIONERS: P. HENDRICKSON, M. JOHNSON, R. JOHNSON

EXCUSED: R. JOHNSON

GUIDING DECISION

BEFORE THE UTAH STATE TAX COMMISSION

PETITIONER, Petitioner, v. AUDITING DIVISION OF THE UTAH STATE TAX COMMISSION, Respondent.	FINDINGS OF FACT, CONCLUSIONS OF LAW, AND FINAL DECISION Appeal No. 06-0179 Account No.: ##### Tax Type: Sales Tax Audit Period: 12/01/00 – 9/20/04 Judge: Phan
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Presiding:

Marc Johnson, Commissioner

Jane Phan, Administrative Law Judge

Appearances:

For Petitioner: PETITIONER REP, CPA

For Respondent: RESPONDENT REP 1, Assistant Utah Attorney General
RESPONDENT REP 2, Manager, Sales Tax Auditing
RESPONDENT REP 3, Auditor

STATEMENT OF THE CASE

This matter came before the Utah State Tax Commission for a Formal Hearing on February 13, 2008. Based upon the testimony and evidence presented at the Formal Hearing, the Tax Commission hereby makes its:

FINDINGS OF FACT

1. The matters before the Tax Commission in this appeal are PETITIONER's appeal of Respondent's denial of a refund request for the period of December 1, 2000 through September 20, 2004 ("Refund Request"), and a sale and use tax audit deficiency for the period March 1, 2002 through January 1,

2005 (“Audit Deficiency”).

2. The Original Statutory Notice regarding the refund had been issued on February 21, 2006. Pursuant to the Respondent’s audit of the refund request, Respondent issued to Petitioner a refund of tax in the amount of \$\$\$\$\$. Subsequently, Respondent amended the audit of the refund request. The amended notice regarding the refund request was issued on March 7, 2007, and indicated an additional refund of tax in the amount of \$\$\$\$\$.

3. The Statutory Notice of Audit Change regarding the Audit Deficiency for the period of March 1, 2002 through January 31, 2005 was originally issued on December 29, 2005. Respondent issued an Amended Statutory Notice of Audit Change on March 7, 2007. The amount of sales and use tax deficiency indicated in the Amended Audit was \$\$\$\$\$ along with interest accruing thereon. No penalty was assessed with the audit.

4. Petitioner meets the SIC code requirements for a manufacturing facility located in Utah. Its DIVISION manufactures PRODUCT pursuant to customer construction specifications. Customer contracts normally require that the DIVISION create and deliver blueprints showing the precise design of the PRODUCT. There is also a DIVISION that acquires raw MATERIALS and manufactures high precision PRODUCTS to its customers’ exact specifications.

A. Normal Operating Replacements

5. The Refund Request and Audit Deficiency have been narrowed to three issues. The first being individual invoices involving purchases of items of personal property, which Petitioner asserts are exempt under the manufactures exemption as normal operating replacements as set forth in Utah Code Ann. 59-12-104(14). The invoices for all of these items were found in Petitioner’s repair and maintenance accounts. There were only one or two parts per invoice that related to any one individual piece of machinery and from

this the Division concluded that these purchases were not part of a full overhaul or rebuild of a piece of machinery.

6. The first item was described by Petitioner as an O-Ring, Gasket and Roller; which Petitioner indicated were parts for a forklift. At the hearing WITNESS A, Supervisor Mobile Equipment Maintenance, testified that these parts were actually purchased after a complete overhaul of the forklift. He testified that he purchased these types of items in advance, so that they would be available if the forklift broke down. He also testified that the fork lifts would have to be overhauled after every 5000 hours of use, which could be from 2.5 to 5 years time depending on the forklift. He testified he had purchased these parts after a complete overhaul, to have on hand for future use. During his testimony at the hearing he did not know when these parts at issue were actually used, or if they had been used as part of a total rebuild of the forklift, or as a repair because the forklift had broken down.

7. The second item was a Ross P/N Silencer. This was purchased to replace a silencer that had exceeded its useful life of 10 years. This was not a repair, but instead a replacement. The Ross P/N Silencer was an improvement over the prior silencer. This item was a piece of machinery or equipment, not just a small part of a much bigger machine like the other items. The Silencer helps eliminate the noise associated with the use of a pneumatic system. The Silencer is not part of the manufacturing process, but was necessary for safety of the workers. A witness for Petitioner, WITNESS B, Maintenance Supervisor, indicated that he was unaware if the device was required by OSHA standards, but that the pneumatic system produced such a significant amount of air pressure, without the use of the silencer, it would damage employees' ears. Overall the evidence indicated that this silencer was necessary for safety reasons, but that it was not a piece of manufacturing machine or equipment.

8. The third group of items was a (X) Bore Sprocket and (X) 1 Inch Bore. These are

sprockets used on the power roller. They are expected to last 3 years or more. These parts were used to move a large and heavy product through the stages of (X) and (X). They were installed between motors and power rollers, WITNESS B testified that the rollers did not wear out as they were made of MATERIALS. The sprocket would wear out and have to be replaced two or three times before the roller. From the information presented these items were used to replace parts that were no longer functioning.

9. The fourth item was a (X) 7/16 Bore Sprocket. This part was a generic sprocket used in the Pait-O-Matic machine. The Paint-O-Matic had been purchased in 1991 and had been assigned a 10-year life. Petitioner has rebuilt this machine several times. These sprockets are purchased separately from the motor, and separately from the equipment to which the power is driven. The information indicated that these items were used to replace parts that were not functioning.

10. The fifth group of items was the Timken (X) Bearing and (X) Spring Disc. The bearing was replaced concurrently with the hand over hand puller system in the cold finish plant. The spring disc controls the tension of bearings on the cams, and must be replaced every ten years, along with the other component parts. The spring disk and bearing make up a sub-operation that takes place within the Miyazaki coil line, which was purchased in 1984 with an original useful life of eight years.

11. The sixth group of items was the (X) Thompson Rail X 4 FT LG and (X) Thompson Bearing. The Division conceded the rail would qualify for the exemption. Petitioner conceded the bearing would not qualify.

12. The seventh group of items was the (X) Clutch Assembly (X) Flywheel and (X) Bearing. These are replacement parts that were purchased in anticipation of a break down of the Pannier metal tag machine, which was purchased in 1981 and assigned a useful life of 10 years. Petitioner's witness, WITNESS B testified that the clutch assembly had been changed three or four times from when this item was

purchased and every other part in the Pannier had been rebuilt or changed over the years. He also indicated that the Pannier was completely overhauled last year (2007).

13. The last, or eighth item in this category was the (X)Bronze Pump. At the hearing, the Division conceded that this item was exempt.

B. Special Foundation

14. In addition to specific invoices with items of personal property, it was Petitioner's position that the purchase of a special foundation was exempt from tax under Utah Code Sec. 59-12-104(14). The foundation was constructed in the former PLANT. Petitioner cut a large hole in the slab floor and excavated a 15-foot deep hole in order to create an extraordinary foundation upon which a large piece of manufacturing equipment would be attached.

C. Blue Print Computers

15. Petitioner also argued that certain computers which were purchased so that Petitioner could create blueprints should be exempt. Petitioner's contracts with its customers for PRODUCT generally require that Petitioner create and deliver a draft of the blueprints. The customers then send the blueprints for approval by architects and building inspectors. When the blueprints are finalized, Petitioner inputs the information into the floor computers. The floor computers control the manufacturing of the PRODUCT. The final blueprints are shipped with the final product. The blueprints are used by the customer as instruction on how to install and attach the joists, and are kept for future reference. The charge for the blueprints are not separately priced or separately stated in the contract.

APPLICABLE LAW

1. For transactions that would otherwise be subject to sales and use tax, Utah law provides for a number of exemptions from taxation in Utah Code Ann. §59-12-104. The Utah Legislature has adopted a

statute that exempts certain sales of tangible personal property used in a manufacturing facility from sales tax.

For the years at issue, Section 59-12-104 (14) (2005)¹ provided, in pertinent part:

The following sales and uses are exempt from the taxes imposed by this chapter:

....

(14)(a) the following purchases or leases by a manufacturer on or after July 1, 1995:

(i) machinery and equipment:

(A) used in the manufacturing process;

(B) having an economic life of three or more years; and

(C) used:

(I) to manufacture an item sold as tangible personal property; and

(II) in new or expanding operations in a manufacturing facility in the state; and

(ii) subject to the provisions of Subsection (14)(b), normal operating replacements that:

(A) have an economic life of three or more years;

(B) are used in the manufacturing process in a manufacturing facility in the state;

(C) are used to replace or adapt an existing machine to extend the normal estimated useful life of the machine; and

(D) do not include repairs and maintenance;

....

2. For purposes of the manufacturing exemption and during the periods at issue, Utah Admin.

Rule R865-19S-85 (2005)² provided:

A. Definitions:

2. "Machinery and equipment" means:

a) electronic or mechanical devices incorporated into a manufacturing process from the initial stage where actual processing begins, through the completion of the finished end product, and including final processing, finishing, or packaging of articles sold as tangible personal property. This definition includes automated material handling and storage devices when those devices are part of the

1 In this Decision the 2005 version of the Utah Code will be referred to for ease of reference. Although the applicable statutory provisions remain substantially the same throughout the audit period, some of the subsections were renumbered over this period. However, subsequent to the audit period, in 2006, the Manufacture's Exemption was substantially revised regarding replacement parts.

2 Utah Admin. Rule R865-19S-85 as revised in 2002. The rule remained the same from 2002 though 2005. For ease of references the Commission cites to the 2005 rule and did not consider the revision to materially affect the decision for the 2000-2001 period.

- integrated continuous production cycle; and
 - b) any accessory that is essential to a continuous manufacturing process. Accessories essential to a continuous manufacturing process include: (i) bits, jigs, molds, or devices that control the operation of machinery and equipment; and (ii) gas, water, electricity, or other similar supply lines installed for the operation of the manufacturing equipment, but only if the primary use of the supply line is for the operation of the manufacturing equipment.
- B. The sales and use tax exemptions for new or expanding operations and normal operating replacements apply only to purchases or leases of tangible personal property used in the actual manufacturing process.
- 1. The exemptions do not apply to purchases of real property or items of tangible personal property that become part of the real property in which the manufacturing operation is conducted.
 - 2. Purchases of qualifying machinery and equipment or normal operating replacements are treated as purchases of tangible personal property under R865-19S-58, even if the item is affixed to real property upon installation.

...

- C. Machinery and equipment or normal operating replacements used for a non-manufacturing activity qualify for the exemption if the machinery and equipment or normal operating replacements are primarily used in manufacturing activities. Examples of non-manufacturing activities include:
- 1. research and development;
 - 2. refrigerated or other storage of raw materials, component parts, or finished product; or
 - 3. shipment of the finished product.

3. A taxpayer must maintain appropriate records to establish that a purchase is exempt. Utah

Admin. Rule R865-19S-85(E) provides as follows:

The manufacturer shall retain records to support the claim that the machinery and equipment or normal operating replacements are qualified for exemption from sales and use tax under the provisions of this rule and Section 59-12-104.

DISCUSSION

In this matter there was little disagreement between the parties regarding the facts, Petitioner, however, argued for a different interpretation of the law from the position taken by the Division in the Refund Request and the Audit Deficiency. The Commission notes that most of the issues were resolved between the parties,

prior to the matter coming to the hearing. All three issues that remained unresolved at the hearing involved the interpretation of the Manufacturers' Exemption at Utah Code Sec. 59-12-104 (14). Both refund and audit periods at issue occurred prior the 2006 revision to the Manufacturers' Exemption, which did change the law substantively. The Commission, however, must apply the substantive law in effect during the audit period. Additionally in applying the facts established to the applicable law, the Commission must consider that the issues presented in this matter are tax exemption issues. It is a well-settled principal of law³ that tax exemption statutes are narrowly construed against the taxpayer.

The first issue presented at the hearing encompassed a number of purchases, which Petitioner argued should qualify for exemption from sales tax as machinery and equipment that were normal operating replacements. The second issue consists of specially constructed concrete footings made so that Petitioner could anchor a piece of machinery for absolute stability during operation. The third issue was a computer system used for producing blue prints. The Commission considers each of these issues in turn.

A. Items Claimed to be Normal Operating Replacements.

Utah Code Sec. 59-12-104(14) provides an exemption from sales tax on a manufacturer's purchases of certain types of machinery and equipment. There was no dispute that Petitioner would, in fact, qualify as a manufacturer for purposes of the exemption. The question was whether the actual items purchased fell under the statutory definitions of "machinery and equipment" or "normal operating replacements" as defined in the statute for purposes of the exemption.

As noted above in the findings, Petitioner claimed eight purchases would be exempt as "machinery" or "normal operating replacements" under Utah Code Sec. 59-12-104(14). Prior to the Formal Hearing the parties agreed on two more of these items, leaving six at issue for the hearing. Of the six items, the Ross

³ See *CASE A v. Auditing Div.*, 842 P.2d 876, 880 (Utah 1992); *CASE B. v. State Tax Comm'n*, 617 P.2d 397, 398 (Utah 1980); *SF Phosphates LTD v. Auditing Div.*, 346 Utah Adv. Rep. 18 (Utah 1998); and *MacFarlane v. Utah State Tax Comm'n*,

Silencer was clearly an item of machinery or equipment, but its purpose was safety and not manufacturing. Regardless that the Ross Silencer was necessary to prevent ear damage to employees in the manufacturing facility, it is not manufacturing equipment and is not exempt pursuant to Utah Code Sec. 59-12-104 (14).

Regarding the five remaining items, the Commission notes that they were not items of machinery or equipment; instead they were parts or components of machinery or equipment. Therefore, the Commission must consider Sec. 59-12-104(14)(a)(ii) which provides an exemption for certain normal operating replacements. From the invoices, it appears that these remaining items were purchased individually or as two small parts of a much larger machine, indicating that these parts were not purchased as part of a total overhaul or total rebuild of a machine. The testimony at the hearing supported that the remaining five purchases generally had an economic life of three years or more as required at Utah Code Sec. 59-12-104(14)(ii)(A); and were used in the manufacturing process, in a manufacturing facility located in Utah as required by Sec. 59-12-104(14)(ii)(B). It is the requirements at Section 59-12-104(14)(ii)(C)&(D), however, that are the issue. Based on Subsection (C) & (D), the Commission must consider whether the part was purchased to “adapt an existing machine to extend the useful life” (emphasis added) and was not for repairs or maintenance.

When interpreting a statute, the Commission looks first to the plain language of the statute⁴ The Commission gives the terms of the statute their ordinary meaning. When interpreting a statute the Commission must assume that each term included in the statute was used advisedly. See *MacFarlane v. Utah State Tax Comm’n*, 2006 UT 25 (2006). Further, where the Legislature has not specifically defined the word the

2006 UT 25 (2006).

⁴ In *Hart v. Salt Lake County Comm’n*, 945 P.2d 125, 138 (Utah 1996) (citations omitted) the Court stated, “the primary rule of statutory interpretation is to give effect to the intent of the legislature in light of the purposes the statute was meant to achieve, and the best evidence of the legislature’s intent is the plain meaning of the statute. In *Hercules, Inc. v. Utah State Tax Comm’n*, 21 P.3d 231 (Utah Ct. App. 2000) the court indicated that if a statute fails to define a word, one would use the dictionary definition or usual meaning. In *MacFarlane v. Utah State Tax Comm’n*, 2006 UT 25 (2006) the Court stated, “In undertaking statutory construction, “we look first to the plain language of a statute to determine its meaning. Only when there is ambiguity do we look further.” (citation omitted) Moreover, “when examining the plain language we must assume that each term included in the [statute] was used advisedly.” (Citations omitted).

Commission considers its ordinary or dictionary definition. See *Hercules, Inc. v. Utah State Tax Comm’n.*, 21 P.3d 231 (Utah Ct. App. 2000). Instead of phrasing the exemption to encompass all replacement part purchases that extended the useful life, the Legislature placed the limitation that the item purchased must “adapt” the existing machine to extend the useful life and not for repairs or maintenance.

Webster’s II New Revised University Dictionary defines “adapt” as follows: “To adjust to a specified use or situation.” It is clear that in drafting the statute in this manner the Legislature did not provide the exemption merely for items used to replace a broken part with the same part, but instead the exemption applies to items used to replace a part, which may or may not be broken, with something that would result in an adjustment to the machine that would extend its useful life. Webster’s II New Revised University Dictionary defines “repair” as to “restore to sound condition after damage . . . [to] fix.”

Petitioner did not provide evidence that would support a finding that these parts were used to adapt machinery to extend its useful life. These parts were not used, or at least it was not shown that they were used, in a major overhaul of a piece of machinery. The testimony for many of these items was that parts were purchased in advance and to have on hand when the equivalent part in the machine broke down. Then Petitioner’s employees would replace the broken part. If the parts were installed in a piece of machinery because the equivalent part in the machine no longer functioned and without its function the machine, or component of the machine in which it was used, would no longer operate, replacing the broken part is a repair. The Commission notes that the evidence presented was that several of the machines in which the parts at issue had been installed had already exceeded their economic life. Therefore, replacement of parts would generally extend its useful life. However, if the part was installed to replace a part that was no longer functioning, this becomes a repair, which is specifically not exempt from sales tax.

Petitioner argued that the Division’s interpretation of the statute was unworkable. The Commission

points out that the Utah Legislature revised the Manufacturers' Exemption effective July 2006, to allow normal operating repair or replacement parts to receive the exemption. Respondent pointed to the fact that there had been a fiscal note attached to this legislative change, which would make it clear that the change was broadening the scope of the exemption. However, the Commission must apply the substantive law in effect during the audit period and that law did not provide for exemption for parts purchased for repairs or maintenance.

Petitioner is required to retain records to support the claim of exemption. See Utah Admin. Rule R865-19-85(E). When these parts were purchased the invoices were accounted for as repairs and maintenance. Petitioner's witnesses at the hearing provided some general information on what the parts were and the machines on which they were used, but not information specific enough to show that these parts were purchased for anything more than repairs.

B. Concrete Footings.

Concrete footings are not items of machinery and equipment and, therefore, are not exempt pursuant to Utah Code Sec. 59-12-104(14). As Respondent noted at the hearing, Utah Rule R865-19S-85(B)(1) specifically provides that the Manufacturer's Exemption does not apply to purchaser of real property or items of tangible personal property that become part of the real property in which the manufacturing operation is conducted. The concrete footings are not machinery and equipment.⁵ Respondent indicates the machinery and equipment are defined by Utah Admin. Rule R865-19S-85. This rule makes it clear that machinery and equipment are electronic or mechanical devices incorporated into the manufacturing process. Concrete footings are not electronic or mechanical devices, and therefore are not exempt from sales tax as machinery or equipment.

⁵ The Division cited to *Morton International, Inc. v. Auditing Division of the Utah State Tax Comm'n*, 814 p.2d

C. Computers and Printers used for Blueprints.

It was Petitioner's position that its purchase of certain computers used in its process to design blueprints should be exempt as manufacturing equipment pursuant to Utah Code Sec. 59-2-104 (14). Petitioner manufactures PRODUCT which are used in construction of real property. Before the joists can be manufactured, Petitioner must first deliver the blueprints of the joists to its customers. These blueprints must be submitted for approval to building inspectors and the customer's architect. After the blueprints are finalized a copy is printed for the customer and the specifications from the blueprints are inputted into the floor computer which operates the manufacturing equipment. A copy of the final blue print is given to the customer with the PRODUCT.

From the information discussed about this process at the hearing, once the design is completed, it is not sent directly into production from these computers at issue. The data first has to be inputted to the floor computers. The floor computers control the machines so that they cut, measure and drill the component parts to the exact specifications needed. The Commission agrees with Respondent that the computers used to design the blueprints are not part of the continuous manufacturing process. These are not items of "manufacturing equipment" pursuant to Utah Admin. Rule R865-19S-85(A)(2) and are not used in the "actual manufacturing process," as required in Utah Admin. Rule R865-19S-85(B).

CONCLUSIONS OF LAW

1. In Utah Code Sec. 59-12-104 (14)(a)(ii) the Legislature provided a statutory definition of "normal operating replacements." Pursuant to the definition the item must have an economic life of three or more years, be used in the manufacturing process in a manufacturing facility, be used to replace or adapt an existing machine to extend the normal estimated useful life of the machine and that the purchase not be for

581 (UT 1991) in support of its position that the special foundation did not qualify for the exemption.

repairs and maintenance. It is the Commission's conclusion that the factual evidence available did not support the position that the items Petitioner claimed to be normal operating replacements were anything more than repairs and maintenance.

2. As Respondent noted at the hearing, Utah Rule R865-19S-85(B)(1) specifically provides that the manufacturer's exemption does not apply to purchases of real property or items of tangible personal property that become part of the real property in which the manufacturing operation is conducted. Machinery and equipment are defined by Utah Admin. Rule R865-19S-85. This rule makes it clear that machinery and equipment are electronic or mechanical devices incorporated into the manufacturing process. The concrete footings are not electronic or mechanical devices and they have been incorporated into the real property. This purchase does not meet the requirements for exemption from sales and use tax under Utah Code Sec. 59-12-104 (14).

3. The computers used to design the blueprints are not items of "manufacturing equipment" pursuant to Utah Admin. Rule R865-19S-85(A)(2) and are not used in the "actual manufacturing process" as required in Utah Admin. Rule R865-19S-85(B).

DECISION AND ORDER

Based on the foregoing, the Commission denies Petitioner's appeal in this matter, other than as to the items that the parties had previously resolved as noted in the Findings of Fact. It is so ordered.

DATED this _____ day of _____, 2008.

Jane Phan
Administrative Law Judge

Appeal No. 06-0179

BY ORDER OF THE UTAH STATE TAX COMMISSION:

The Commission has reviewed this case and the undersigned concur in this decision.

DATED this _____ day of _____, 2008.

Pam Hendrickson
Commission Chair

R. Bruce Johnson
Commissioner

Marc B. Johnson
Commissioner

D'Arcy Dixon Pignanelli
Commissioner

Notice of Appeal Rights: You have twenty (20) days after the date of this order to file a Request for Reconsideration with the Tax Commission Appeals Unit pursuant to Utah Code Ann. §63-46b-13. A Request for Reconsideration must allege newly discovered evidence or a mistake of law or fact. If you do not file a Request for Reconsideration with the Commission, this order constitutes final agency action. You have thirty (30) days after the date of this order to pursue judicial review of this order in accordance with Utah Code Ann. §59-1-601 and §63-46b-13 et seq.

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